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USE DISCLAIMERS TO ADD FLEXIBILITY AND HINDSIGHT TO ESTATE PLANS

With transfer tax rules currently in a state of flux, qualified disclaimers gain usefulness as a postmortem tool that can serve as a defensive device or proactive planning technique.

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The disclaimer can be a helpful tax and estate planning tool if used correctly. Often, the disclaimer is employed as a postmortem remedial device to fend off adverse tax repercussions and other unintended consequences of an estate plan gone awry. Other times, the anticipated use of the disclaimer is consciously incorporated into the estate plan by its drafter to preserve tax and distributive flexibility at the decedent's death. Although, this article focuses on the application of the disclaimer in the estate tax context, significant nontax objectives may also justify its use.

Disclaimer basics

The disclaimer, in its broadest sense, is the irrevocable refusal to accept the ownership of property passing gratuitously by:

1. Inter-vivos (i.e., lifetime gift) transfer.
2. Testamentary (i.e., bequest at death) transfer.
3. Operation of law (e.g., joint tenancy with right of survivorship, intestacy, or payment on death).

Historically governed by common law,[1] disclaimers are now codified by state statute and are further regulated by the Internal Revenue Code for transfer tax purposes.[2] Under the Code, a "qualified disclaimer" results in the disclaimed property being treated as if it had never been transferred to the disclaimant for federal estate, gift, and generation-skipping transfer (GST) tax purposes.[3] Thus, when disclaimed in a "qualified" manner, property will pass to the alternate beneficiary named in the transfer document, or to another beneficiary by operation of law, without ever being received by the disclaimant.

For a disclaimer to be "qualified" for tax purposes, Section 2518(b) establishes four basic requirements:

1. The refusal must be in writing.[4] This written document must identify the interest in the disclaimed property and must be signed either by the disclaimant or by the disclaimant's legal representative.
2. The refusal must be delivered to the proper party by nine months after the

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later of (a) the date of the transfer creating the interest; or (b) the disclaimant's 21st birthday.[5] The proper party to whom the refusal should be delivered is the transferor of the interest, the transferor's legal representative, the holder of the legal title to the property to which the interest relates, or the person in possession of the interest.[6]

3. The disclaimant must not have accepted the interest or any of its benefits.[7]
4. The disclaimed interest must pass without any direction on the part of the disclaimant to a person other than to the disclaimant.[8] (The transferor's spouse, however, may disclaim an interest in property while still retaining the same interest after it has been disclaimed.[9] Thus, a spouse may disclaim an interest in a marital deduction trust to have the interest pass to a nonmarital trust in which the spouse has an interest; however, the spouse may not retain a power of appointment over the nonmarital trust unless the power is limited by an ascertainable standard or a "5 and 5" power.[10])

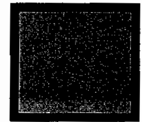
In addition to these requirements, a "qualified disclaimer" must also generally comply with the applicable disclaimer statute of the state with jurisdiction over the transferred property.[11] If the disclaimer fails to meet these requirements, the disclaimed property will be deemed to have been first received by the disclaimant and subsequently transferred by the disclaimant to the alternate recipient, resulting in unintended and costly transfer tax consequences.[12]

Changes in federal and state law

Even under the best of circumstances, estate planning is an inherently speculative endeavor—laden with uncertainty, conjecture, and unanticipated potential for liability. After all, estate planners are asked to recommend tax-efficient strategies for distributing their clients' assets without the benefit of knowing:

1. When their clients will die.
2. Which beneficiaries will survive their clients.
3. Whether (and which) assets will be available for distribution at their clients' death.
4. What tax laws and regulations will be in effect at that time.

The speculative nature of this process has been exacerbated by recent legislative changes at both the federal and state levels, with further modification and reform anticipated in the near future. Although intended to relieve taxpayers from the oppressive transfer tax regime, these legislative revisions have unintentionally hampered the estate planner's ability to anticipate the transfer tax—thereby frustrating attempts to eliminate or minimize its impact through planning.



A DECEDENT'S SURVIVING SPOUSE, CHILDREN, AND OTHER BENEFICIARIES ARE ALLOWED A "MONDAY MORNING QUARTERBACK" VIEW OF HOW THE DECEDENT'S ASSETS SHOULD PASS.

EGTRRA. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) offers taxpayers two main forms of federal estate tax relief:

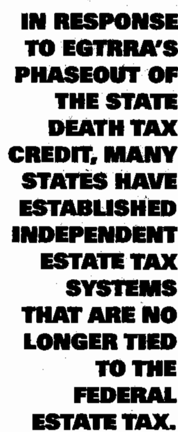
1. It provides for a gradual reduction in the maximum estate tax rate from 55% in 2001 to 45% in 2009.
2. It progressively raises the applicable exclusion amount, (i.e., the value that each taxpayer may transfer free from federal estate tax). This amount was increased to $1 million in 2001 and will gradually rise to $3.5 million in 2009. In 2005, the applicable exclusion amount is $1.5 million.

If the laws under EGTRRA remain unchanged, the federal estate tax and GST tax will be repealed entirely in 2010, while the gift tax for lifetime transfers will remain at $1 million. This presents no cause to celebrate just yet, however, because the repeal is only temporary. The estate tax and GST tax will return in 2011 to their previous top marginal rate of 55%, and the applicable exclusion amount will be $1 million.

With the applicable exclusion amount currently scheduled to range between $1.5 million and $3.5 million over the next several years, a one-year estate tax repeal looming after that, and permanent repeal still a possibility, counseling clients under EGTRRA is a daunting task. The difficulty of this undertaking is compounded when dealing with married couples, due to the likelihood of the spouses' deaths in different years with different tax laws and rates in effect.

Decoupling of federal and state estate tax. Prior to 2001, most states imposed their own state level "death tax" by reference to the state death tax credit provided under federal law. (For purposes of this article, the term "death tax" refers collectively to the estate, inheritance, legacy, or succession taxes that many states charge on the gratuitous transfer of property

at death.) In such tax systems, known popularly as "pick-up tax," "soak-up tax," or "sop-up tax" regimes, the death tax liability would equal the maximum state death tax credit allowed on the federal estate tax return under Section 2011. In essence, these "pick-up tax" states collected the portion of the federal estate tax liability that was reduced by the state death tax credit; thus, the total state and federal tax liability was no higher than the federal estate tax alone would otherwise have been.



IN RESPONSE TO EGTRRA'S PHASEOUT OF THE STATE DEATH TAX CREDIT, MANY STATES HAVE ESTABLISHED INDEPENDENT ESTATE TAX SYSTEMS THAT ARE NO LONGER TIED TO THE FEDERAL ESTATE TAX.

EGTRRA, however, gradually reduced and then eliminated the credit. The dollar-for-dollar federal credit for state death taxes paid was reduced by 25% in 2002, 50% in 2003, and 75% in 2004.[13] In 2005, the state death tax credit was eliminated under Section 2011(f). The credit was replaced, in 2005, with an unlimited deduction in Section 2058 for state death taxes paid.

In response to EGTRRA, and a potential loss of state tax revenue, many of the "pick-up tax" states "decoupled" their death tax systems from the federal estate tax, by establishing state death tax regimes with no ties to the federal estate tax. Other states, such as New Jersey, now base their death tax on the federal estate tax laws in effect prior to EGTRRA. The upshot of these changes is that "pick-up tax" states now (1) potentially subject the estates of many taxpayers to a state death tax even if no federal estate tax is due, and (2) may impose a state death tax that must be paid in addition to the full federal estate tax.

Defensive and proactive planning

The shifting nature of the applicable exclusion amount, the decoupling of state and federal estate tax systems, and the potential for permanent repeal of the federal estate tax require estate plans to be drafted with flexibility. Many avenues exist to incorporate flexibility into an estate plan; however, few, if any, of these techniques are as versatile and effective as the disclaimer. Through its proper use, a decedent's surviving spouse, children, and other beneficiaries are allowed a "Monday morning quarterback" view of how the decedent's assets should pass (for up to nine months after date of death or even longer if the disclaimant is under 21). A savvy drafter will incorporate these techniques into an estate plan from the outset.

Marital deduction planning. The most common estate plan for couples faced with a potential estate tax liability for assets in excess of the applicable exclusion amount is the simple marital deduction/credit shelter trust, sometimes referred to as the A/B Trust. At the first spouse's death, his or her estate is divided into two shares:

1. A bequest equal to the decedent's remaining applicable exclusion amount, which is held in trust for the benefit of the surviving spouse and children.
2. The balance of the estate, which passes to or for the benefit of the surviving spouse in a manner that qualifies for the marital deduction (e.g., through an outright bequest or to a qualified terminable interest property (QTIP) trust).

With this division of assets at the death of the first spouse, no estate tax is due because the estate is completely sheltered by the applicable exclusion amount and marital deduction; moreover, both spouses' estate tax credits are employed. Without such a plan, the estate tax credit of the first spouse to die is typically squandered.

Although such plans are generally sufficient for large estates, modest-sized estates may encounter difficulty with the marital/credit shelter division as the applicable exclusion amount rises. Under EGTRRA, the relative size of the marital and credit shelter bequests will fluctuate. For example, in an estate valued at $5 million, the credit shelter share will be smaller than the marital share from 2005 through 2008; however, it will be larger in 2009. (The credit shelter—i.e., the applicable exclusion amount—is scheduled to increase from $1.5 million in 2005 to $2 million in 2006, to $3.5 million in 2009.) In 2010, of course, the need for a marital deduction/credit shelter split will be eliminated altogether due to the one year repeal of the estate tax. Drafting for such changes in a will or trust document may be impractical, especially for clients who would prefer an outright disposition of their assets if there were no obvious tax benefits to keeping the property in trust. Such clients should consider the use of a disclaimer.

By incorporating the use of a disclaimer into a plan, the entire estate can be devised to the surviving spouse who can then determine with certainty, whether and how much to disclaim to take full advantage of the laws then in effect. The property disclaimed can be set up in the estate plan to pass, at the time of disclaimer, to a trust for the benefit of the sur-

viving spouse, such as a credit shelter trust; alternatively, it may be directed to pass outright to other beneficiaries, such as children or grandchildren, or to remain in trust for their benefit. The surviving spouse, however, may not have a power of appointment—either as a trustee or be entitled to principal—except that a spouse may have a "5 × 5 power," and may receive principal distributions in the discretion of a co-trustee or based on an ascertainable standard or otherwise, the spouse will possess an impermissible retained interest in the disclaimed property.

State death tax planning. As explained above, in response to EGTRRA's phaseout of the state death tax credit, many states have established independent estate tax systems that are no longer tied to the federal estate tax. For example, effective 1/1/04, the New York and federal estate tax no longer work in tandem. The applicable exclusion amount recognized by New York for state estate tax purposes is frozen at $1 million, while the federal applicable exclusion amount is currently $1.5 million and set to rise next year.

Therefore, by establishing a credit shelter trust of $1.5 million in 2005 in order to take advantage of the maximum federal applicable exclusion amount on the death of the first spouse, a New York estate tax of $64,400 will be incurred even though no federal estate tax is due. In 2006, when the federal applicable exclusion amount is increased to $2 million, a New York estate tax of $99,600 will be incurred if the credit shelter amount is set at $2 million.

To avoid New York estate tax, the credit shelter trust could be limited to the maximum New York applicable exclusion amount of $1 million. However, an additional $500,000, which could have been sheltered on the first spouse's death and would have been free from federal estate tax on the death of the second spouse, would then be subject to federal estate tax (including any appreciation) on the death of the second spouse.

With the flexibility provided by the disclaimer, this problem may be postponed or eliminated. The estate planning documents could provide that all of the decedent's assets pass to the surviving spouse outright or in trust (or alternatively, the maximum amount that can pass free from New York estate tax is used to fund a credit shelter trust) with additional flexibility for the surviving spouse to disclaim further assets into a credit shelter trust. The decision will be left to the surviving spouse, at the time of the decedent's death, regardless of whether he or she is willing to pay some state estate tax, in order to defer more federal estate tax. In addition, if the laws have changed between the time the estate planning documents were drafted and the date of the decedent's death, additional flexibility may be accomplished through the disclaimer.

Charitable planning. If the client wishes to leave money to a charity, the drafter could insert a bequest to a spouse or other family member of the assets intended for that charity with a contingency clause directing the assets to the charity if the noncharitable beneficiary disclaims the bequest. If the client dies after the

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estate tax repeal or when the decedent's applicable exclusion amount is sufficient to eliminate estate taxes, the noncharitable beneficiary may accept the assets that the decedent intended for the charity and then make a charitable contribution (eligible for an income tax deduction) to the charity. If an estate tax liability would otherwise be generated without the estate tax charitable deduction, the noncharitable beneficiary can disclaim as much of the bequest as necessary to reduce estate taxes to a minimum. This approach, sometimes referred to as a "reduce-to-zero" charitable bequest, is commonly employed by charitably inclined clients without any children or immediate descendants.

NUMEROUS CASES ILLUSTRATE ADVERSE TAX CONSEQUENCES AND UNINTENDED DISTRIBUTIVE RESULTS OF DISCLAIMERS THAT DO NOT MEET THE RIGID REQUIREMENTS OF THE CODE AND STATE LAW.

Employee benefit planning. Beneficiary designations for proceeds of IRAs and other employee benefit plans should always be current. When they are not up-to-date, a disclaimer can be used to undo any unintended tax consequences. Rulings on cases involving disclaimed retirement benefits confirm that the ultimate recipient, not the disclaimant, is taxed on the income associated with the disclaimed benefits.[14] Thus, when a primary beneficiary is in a higher tax bracket or wishes to share the proceeds with contingent beneficiaries, a disclaimer can be used to pass all or part of the proceeds to beneficiaries in lower income tax brackets.[15]

Example. Michael intended for all of his children to receive equal inheritances at his death. He inadvertently, however, designated only one of the children as sole beneficiary of an IRA. Michael's will accurately reflects his intent and divides the residuary estate equally among his children taking into account all of his assets passing through his will or outside his will. Rather than the one child being taxed on the entire income generated by the IRA proceeds, the designated child could disclaim the benefits and allow them to pass equally to all the decedent's children in accordance with the residuary clause in the will.

Other uses for the disclaimer

While the focus of this article is on the use of the disclaimer during this period of "death tax repeal," other potential uses of the disclaimer include, but are not limited to:

1. *Correcting drafting errors.*[16] For example, if a taxable estate was inadvertently created by an insufficient and poorly drafted marital deduction share, the beneficiaries could disclaim in favor of the spouse if he or she is the alternate beneficiary named in the document, or is the alternate beneficiary by operation of law, thereby securing the marital deduction and avoiding estate taxes.
2. *Reducing income tax by shifting assets to a lower income tax bracket.* For example, a beneficiary in a higher income tax bracket could disclaim inherited income-producing assets, which could then pass to an alternate beneficiary in a lower income tax bracket.
3. *Creditor protection.* For example, if the beneficiary's creditors would attach the inherited assets, the beneficiary could disclaim the inheritance, so the assets would then pass to the alternate beneficiary. Note that implementing disclaimers to avoid creditors effectively is dependent on applicable state law. Furthermore, this use of disclaimers is not effective if the U.S. Government is the creditor.[17]
4. *Allowing for the ownership of S corporation shares.*[18] For example, if the beneficiary is an impermissible S corporation shareholder, which would cause the corporation to lose its S corporation status and face disastrous tax consequences, the beneficiary could disclaim the shares that could then pass to a permissible S corporation shareholder.
5. *Permitting alternate valuation.*[19] The executor of an estate may elect to value the gross estate at the alternate valuation date, which is six months from the decedent's date of death, instead of at the time of the decedent's date of death, if both the gross estate and the estate tax is reduced by valuing the property at such later date. Under many circumstances, a disclaimer must be executed in order to reduce the value of the gross estate and the estate tax, thereby permitting alternate valuation.
6. *Permitting special-use valuation.*[20] Section 2032A permits special-use valuation for federal estate tax purposes of certain qualified real property and farm land. Special-use valuation is permitted only if the property passes to a "qualified heir." Under many circumstances, a disclaimer must be executed in order for the property to pass to a "qualified heir."

PLANNING TIP

The following ideas can be implemented to avoid problems when drafting and planning for the anticipated use of a disclaimer:

1. **Always keep in mind the nine-month period for exercising a qualified disclaimer. An estate plan that contemplates the use of a disclaimer should contain provisions that encourage the disclaimant to make a timely decision.**
2. **The careful drafter should clearly state the contingent disposition of the disclaimed assets and should not rely on the default provisions of state intestacy laws. The drafter must be certain of the manner in which the property will pass if it is disclaimed to ensure that the property ends up where the client intended it to go. In short, never use a disclaimer without being certain to whom the property will pass. The best way to assure certainty of a disclaimed asset is to draft for its alternate disposition in the document.**
3. **With the client's permission, assure safe passage of the disclaimer with the client's principal and contingent beneficiaries. A beneficiary who first learns of the possibility of a disclaimer after having just found out about a forthcoming inheritance would be less willing to execute the disclaimer and give up the inheritance. If given advance knowledge of the benefactor's greater purpose or ultimate intent, the beneficiary would be more inclined to cooperate with the contemplated disclaimer.**
4. **The plan should anticipate and specifically authorize a disclaimer by a fiduciary. Under the law of some states, fiduciaries cannot disclaim. In other states, the fiduciary requires court approval to disclaim any property interest unless the governing instrument gives the fiduciary express authorization.**
5. **The beneficiaries must be advised and aware not to exercise any form of control of the assets to be disclaimed; otherwise, the subsequent disclaimer may be invalid.**

7. *Avoiding environmental issues.* For example, if the bequeathed property contains significant environmental liabilities, the beneficiary may prefer disclaiming the property interest rather than dealing with the environmental issues.
8. *Qualifying for redemption treatment.*[21] For example, if the beneficiary's inherited shares in a corporation do not qualify for the tax favorable "redemption" treatment, the beneficiary could disclaim the shares, which could then pass to the alternate beneficiary whose shares qualify for redemption treatment. Note that under current law this makes less of a difference since the tax rates are the same for "qualified dividends" and "redemptions."
9. *Terminating a trust.*[22] For example, if both the current income and remainder beneficiaries wish to terminate a trust, and the successor income beneficiary named in the trust document is the same as the remainder beneficiary, the current income beneficiary could disclaim in favor of the successor income beneficiary/remainder beneficiary. Once the income and remainder beneficiaries are the same, the trust may be terminated under many circumstances.
10. *Permitting a QTIP election.* For example, if a trust under a will fails to qualify for QTIP treatment (i.e., the marital deduction) because an impermissible interest in the trust is bequeathed to a non-spouse, the non-spouse could disclaim the impermissible interest, and the trust could then qualify for QTIP treatment.
11. *Allowing for the ownership or sale under a shareholder's agreement.* For example, if a shareholder's agreement permits the ownership of shares or the sale of shares by only certain individuals, and the shares are bequeathed to a beneficiary who is not a permitted shareholder or is not permitted to sell the shares, the beneficiary could disclaim the shares; they could then pass to an alternate beneficiary who is a permitted shareholder and is permitted to sell the shares.

Caveats

Although disclaimers can provide flexibility to estate plans, they also carry tremendous opportunities to blunder with grave consequences. This section outlines some of the more common errors associated with disclaimers and concludes with recommendations to avoid such errors.

A disclaimer must be executed properly to be effective. Numerous cases illustrate adverse tax consequences and unintended distributive results of disclaimers that do not meet the rigid requirements of the Code and state law. Estate planners must, therefore, understand the rules governing disclaimers. Moreover, it is crucial that estate planners convey these rules to their clients to avoid costly mistakes that could potentially undo the effectiveness of the disclaimer. The following cases are instances where the disclaimer requirements were not met, resulting in costly consequences.

Unintended acceptance. In *Estate of Engelman*,[23] the Tax Court held that a decedent's execution of a power of appointment after her husband's death was an acceptance of the underlying property, thereby precluding a subsequent disclaimer by the administrator of her estate.

Untimely disclaimer. In TAM 200234017, the disclaimer was deemed untimely because the surviving spouse filed the disclaimer with the county court more than nine months after the decedent's death.

Disclaimant direction of the disclaimed property. In *Walshire*,[24] a beneficiary could not keep property out of his estate by disclaiming only a remainder interest in his inherited property while retaining the right to receive income for life. (The disclaimer would have been effective if the beneficiary was the decedent's spouse.)

Unsigned and vague disclaimers. In *Estate of Chamberlain*,[25] on the advice of their attorneys, each spouse executed wills leaving all the assets to the survivor. The wife died, and the husband wrote an informal disclaimer on a piece of paper without specifically listing the disclaimed assets or signing the paper. The Tax Court ruled that the disclaimer was not valid, despite acknowledging that the husband never accepted the interest.

Failure to execute disclaimers. Perhaps the greatest obstacle to a disclaimer-based estate plan is the beneficiary who will not execute the disclaimer. Obviously no reported cases illustrate this problem; yet, many estate planners have experienced this situation—even with the simple disclaimer-based estate plan for the benefit of a spousal beneficiary who refuses to disclaim. For this reason, many estate planners avoid disclaimer-based estate plans because of the uncertainty that the beneficiary will in fact execute the disclaimer on the decedent's death.

Conclusion

During this time of legislative flux regarding the estate tax at both the federal and state levels, even seasoned estate planners find themselves fraught with indecision. Looming doubts as to the applicable exclusion, the effective rate, and the estate tax (if any) that will be due create many planning uncertainties. Although not a panacea, the disclaimer can be an effective tool for addressing these uncertainties. Thus, estate planners need to understand the full potential of the disclaimer as both a lifetime and postmortem planning device. Failure to comprehend and implement the disclaimer, when appropriate, as well as failure to adhere to the rigid requirements of the disclaimer, may result in disastrous federal and state death tax consequences. ■

NOTES

1 See Martin, "Perspectives on Federal Disclaimer Legislation," 46 U. Chi. L. Rev. 316 (1979).
2 Section 2518.
3 *Id.*
4 Section 2518(b)(1).
5 Section 2518(b)(2).
6 Reg. 25.2518-2(b)(2).
7 Section 2518(b)(3).
8 Section 2518(b)(4).
9 Reg. 25.2518-2(e)(2).
10 Reg. 25.2518-2(e)(5), Examples 4, 5, and 6.
11 Reg. 25.2518-1(c)(1).
12 Reg. 25.2518-1(b).
13 Section 2011(b).
14 See GCM 39858, 9/23/91.
15 See e.g., Ltr. Ruls. 9442032, 9319029, 9303027, 9226058, 9037048, 9016026, and 8922036.
16 See Ltr. Rul. 8603030.
17 See Drye, 528 U.S. 49, 84 AFTR2d 99-7160 (1999).
18 See Section 1361.
19 See Section 2032.
20 See Section 2032A.
21 See Section 302.
22 See Ltr. Rul. 8402121.
23 121 TC 54 (2003).
24 288 F.3d 342, 89 AFTR2d 2002-2215 (CA-8, 2002).
25 TCM 1999-181.